Internal Revenue Service
memorandum

CC:TL
Br3:SAHall

date: JUN 06 1986

to: District Counsel, Detroit C:DET

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request dated April 21, 1986, for technical advice in the above-captioned case. This case is being coordinated due to the administrative importance of the issue. [redacted] of this office represented respondent at the Tax Court hearing held on [redacted].

ISSUE

Whether the Internal Revenue Service satisfied the statutory requirement of I.R.C. § 4975(h) that it coordinate a prohibited transaction case with the Department of Labor prior to issuing the statutory notice of deficiency to the petitioner. 4975.07-00.

CONCLUSION

The Internal Revenue Service (hereinafter "IRS") followed all coordination procedures designed jointly by the IRS and the Department of Labor. These procedures properly reflect the requirement of I.R.C. § 4975(h) and the intent of Congress in placing this coordination requirement in the Employee Retirement Income Security Act of 1974 (hereinafter "ERISA"). The petitioner's argument that the statutory notice is invalid is without merit and the petitioner should be forced to litigate the prohibited transaction issue on its merits.

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FACTS

From [redacted] to [redacted] the [redacted] leased land, and an office building thereon, from the [redacted] (hereinafter "Plan"). The monthly amount paid under the [redacted] lease was modified in [redacted] to reflect substantial improvements made on the property. Both the original and modified leases had expiration dates of [redacted] On [redacted], the Plan sold the property to [redacted]. The IRS determined that the sale of the property was a prohibited transaction under I.R.C. § 4974(c)(1)(A). Under the transitional rules of ERISA § 414, the prohibited transaction was the sale at less than fair market value, rather than either the lease or the sale per se.

Having determined that there had been a prohibited transaction in [redacted], the Employee Plan Specialist followed the inter-agency coordination procedures laid out in the "Agreement Between The Internal Revenue Service And The Department of Labor For The Coordination of Examination And Litigation Activities Involving Employee Benefit Plans", signed April 18, 1983, by the Commissioner of the IRS and the DOL Deputy Assistant Secretary for Program Operations. The Specialist prepared Form 6212-B: "Examination Referral Checksheet (To be completed by the EP/EO Examiners for referral to DOL)". Part B of the Form showed that the IRS believed a prohibited transaction had occurred. Attached to the Form was a one page explanation of the transaction and reasons to treat it as a violation under I.R.C. § 4975. The Form 6212-B was sent to the Department of Labor (hereinafter "DOL") on [redacted]. [redacted], of the local DOL office, responded by telephone on [redacted], that they would merely file the referral notice, i.e., not conduct an independent examination, as long as the IRS was following up on the prohibited transaction. This chronology is described in the Specialist's case chronology, on the Form 5466: Record of Disclosure maintained by the Specialist, and in the affidavit executed by the DOL officer and submitted to the Tax Court.

On [redacted], the Specialist held a taxpayer conference with the Vice President (Finance) and the Manager of the Tax Department of [redacted]. The Specialist explained the IRS position that there had been a prohibited transaction. No agreement was reached. The Vice President said to go ahead and set up the prohibited transaction issue unagreed (case chronology). At the hearing counsel for petitioner stated that their "position is that there is no prohibited transaction" (Tr. at 8). In addition, he claimed that petitioner did not have an opportunity to appeal the IRS determination other than orally (Tr. at 15). We assume he is referring to the [redacted] meeting.

The statute of limitations on the taxable year at issue was due to expire on [redacted]. After DOL had commented on the IRS notification of the case in [redacted], the IRS sent to petitioner forms to extend the time within which the IRS had to issue the statutory notice of deficiency. Under questioning by the judge, counsel for petitioner admitted receiving the extension forms "[redacted]" and refusing to sign them.

[redacted]

(Tr. at 16.) We gather that evidence could be obtained from IRS personnel to show that the IRS repeatedly attempted to obtain the execution of these extension forms.

The IRS issued the statutory notice of deficiency on [redacted], based on the prohibited transaction. No thirty day letter had been issued although the taxpayer was informed of the IRS finding, and had had opportunity to object at the [redacted] meeting. According to counsel for petitioner, petitioner received the statutory notice of deficiency on [redacted], and thereupon offered to sign the form for extending the statute of limitations before the original deadline of [redacted] (Tr. at 31). The IRS responded that they were not interested in the waiver once the statutory notice had been issued (Tr. at 32).

Meanwhile, DOL was conducting an investigation of the petitioner. The scope of their investigation is not known but evidently it was not completed at the time the IRS issued the statutory notice of deficiency. According to counsel for petitioner, the DOL investigator held a "closing" conference with representatives of petitioner on [redacted]. Allegedly, the investigator stated at that meeting that he believed a prohibited transaction had occurred, he would report his findings to the DOL regional office, and that he had been instructed "not to afford petitioner any opportunity to correct the alleged prohibited transaction." (Petitioner's Motion to Dismiss at p. 3.) 1/

1/ We note that [redacted] could undo, that is, "correct", the transaction at any time without clearance from either agency. Whether the company would be relieved thereby of all liability connected with the making of the transaction is an entirely separate issue.

Thereafter, petitioner filed a petition in Tax Court on [redacted], and moved to dismiss the case on [redacted] on the ground that the IRS had failed to notify DOL prior to mailing the notice of deficiency.

DISCUSSION

1. Statutory and Administrative Context

When Congress enacted ERISA in 1974, it divided the statutory responsibilities among three agencies: DOL, IRS, and the Pension Benefit Guaranty Corporation (hereinafter "PBGC"). Title I of ERISA is codified under 29 U.S.C. and is administered by DOL; Title II is codified under 26 U.S.C. and is IRS's responsibility; and the PBGC is responsible for Title IV. Title III contains various sections providing for the coordination by the three agencies of matters for which two or more of the agencies have responsibility. Thus, ERISA § 3003(a), codified at 29 U.S.C. § 1203(a), provides:

> Unless the Secretary of the Treasury finds that the collection of a tax is in jeopardy, in carrying out the provisions of section 4975 of Title 26 (relating to tax on prohibited transactions) the Secretary of the Treasury shall, in accordance with the provisions of subsection (h) of such section, <u>notify</u> the Secretary of Labor before sending a notice of deficiency with respect to the tax imposed by subsection (a) or (b) of such section, and, in accordance with the provisions of subsection (h) of such section, afford the Secretary an <u>opportunity</u> to comment on the imposition of the tax in any case. The Secretary of the Treasury shall have authority to waive the imposition of the tax imposed under section 4975(b) in appropriate cases. Upon receiving a written request from the Secretary of Labor or from the Pension Benefit Guaranty Corporation, the Secretary of the Treasury shall cause an investigation to be carried out with respect to whether the tax imposed by section 4975 of Title 26 should be applied to any person referred to in the request. [Emphasis added.]

An abbreviated coordination requirement is contained in Title II, codified at 26 U.S.C. § 4975(h):

> (h) NOTIFICATION OF SECRETARY OF LABOR. -Before sending a notice of deficiency with respect to the tax imposed by subsection (a) or (b), the Secretary shall notify the Secretary of Labor and provide him a reasonable opportunity to obtain a correction of the prohibited transaction or to comment on the imposition of such tax.

Title III contains other similar coordination provisions.

The legislative history of ERISA reflects the Congressional understanding that the IRS and DOL have related jurisdictions but different perspectives. Prohibited transactions are an excellent example. The Conference Report, No. 93-1280, 1974-3 C.B. 415, states that the bill:

> establishes rules governing the conduct of plan fiduciaries under the labor laws (title I) and also establishes rules governing the conduct of disqualified persons (who are generally the same people as 'parties in interest' under the labor provisions) with respect to the plan under the tax laws (title II). This division corresponds to the basic difference in focus of the two departments. The labor law provisions apply rules and remedies similar to those under traditional trust law to govern the conduct of fiduciaries. The tax law provisions apply an excise tax on disqualified persons who violate the new prohibited transaction rules; this is similar to the approach taken under the present rules against self-dealing that apply to private foundations.

> The labor provisions deal with the structure of plan administration, provide general standards of conduct for fiduciaries, and make certain specific transactions "prohibited transactions" which plan fiduciaries are not to engage in. The tax provisions include only the prohibited transaction rules and apply only to disqualified persons, not fiduciaries (unless the fiduciary is otherwise a disqualified person and the transaction involved him, or the fiduciary benefited from the transaction). To the maximum extent possible, the prohibited transaction rules are identical in the labor and tax provisions, so they will apply in the same manner to the same transaction.

Conf. Rep. No. 93-1280 at 295-296, 1974-3 C.B. at 456-457. It is quite clear that Congress foresaw the two agencies investigating the same transaction but viewing the issue of liability from different angles. For example, an owner-trustee might cause the plan to make a prohibited loan to the spouse of the owner-trustee. The IRS would impose the tax on the spouse as the disqualified person while DOL might go after either the owner-trustee for a breach of fiduciary duty owed to the plan or after the wife under its broad equitable powers. _See_ _McDougall v. Donovan_, 539 F. Supp. 596, 599 (N.D. Ill. 1982). As the Conference Report explains, this split in focus comes from already existing concepts in the law.

> Under the labor provisions (title I), the fiduciary is the main focus of the prohibited transaction rules. This corresponds to the traditional focus of trust law and of civil enforcement of fiduciary responsibilities through the courts. On the other hand, the tax provisions (title II) focus on the disqualified person. This corresponds to the present prohibited transaction provisions relating to private foundations. [Footnote omitted.]

Conf. Rep. No. 93-1280 at 306, 1974-3 C.B. at 467. Under the labor provisions, but _not_ the tax provisions, a fiduciary who breaches his duties is personally liable for losses to the plan attributable to the breach as well as for restoring any profits made on the transaction to the plan. The fiduciary may also be subject to removal or other sanction. In contrast, the tax provisions establish a two tier excise tax on the disqualified person who participated in the prohibited transaction.

As mentioned above, Title III of ERISA, as well as 26 U.S.C. § 4975(h), provides for coordination by the two agencies. Part XII of the Conference Report contains the discussion of the Title III coordination provisions. The report repeats the rule that the IRS must "inform the Secretary of Labor before imposing the tax" and that DOL is to have "an opportunity, in other than jeopardy situations [,] to comment on the appropriateness of imposing the tax." In the event DOL obtains correction of the transaction the IRS may waive the 100 percent second tier tax of 26 U.S.C. § 4975(b). Conf. Rep. No. 93-1280 at 359, 1974-3 C.B. at 520. The Report provides further that Congress expects the agencies to coordinate on regulations and guidance, and to establish any necessary boards, task forces or studies necessary to accomplish this aim.

By 1978 it had become clear that there were too many overlapping or duplicate responsibilities for the three agencies, IRS, DOL and PBGC. President Carter submitted to Congress on August 10, 1978, the Reorganization Plan No. 4 of 1978: Employee Retirement Income Security Act Transfers. The Reorganization Plan went into effect on December 31, 1978, under Executive Order 12108, December 28, 1978 (44 F.R. 1065). The President stated in his message that the plan "will eliminate overlap and duplication in the administration of ERISA and help us achieve our goal of well regulated private pension plans." He saw the biggest problem as "overlapping jurisdictional authority." 1978 U.S. Code Cong. & Ad. News, 95th Cong. 2d Sess., at 9814. Section 102 of the Reorganization Plan transfers to the Secretary of Labor:

> (a)regulations, rulings, opinions, and exemptions under section 4975 of the Code,
>
> EXCEPT for (i) subsections 4975(a), (b), (c)(3), (d)(3), (e)(1), and (e)(7) of the Code;
> (ii) to the extent necessary for the continued enforcement of subsections 4975(a) and (b) by the Secretary of the Treasury, subsections 4975(f)(1), (f)(2), (f)(4), (f)(5) and (f)(6) of the Code; [....]

The result of this reorganization is that while DOL has jurisdiction, on the whole, to define the various transactions that will constitute a prohibited transaction (26 U.S.C. § 4975(c)) for purposes of regulations, opinion letters and exemptions, the IRS retains independent control over the assertion of excise taxes in specific cases (26 U.S.C. § 4975(a) and (b)). There are situations in which DOL will look at specific facts and make a determination, such as when someone has applied for an exemption from the otherwise applicable rules of 26 U.S.C. § 4975(c). However, DOL's role is principally in setting the definitional guidelines for prohibited transactions and in pursuing violations of the fiduciary duty rules. The IRS, as administrator of the tax laws, clearly has jurisdiction over the imposition of the excise tax, including any regulations or rulings relating to the manner in which it is imposed. Significantly, the Conference Report makes repeated reference to the excise taxes imposed under the private foundations rules which are wholly administered by the IRS.

The only litigation involving 26 U.S.C. § 4975(h) concerns DOL's attempt to seek restitution for a plan from the interested party in addition to the fiduciary. Unlike [redacted], the nonfiduciary party in interest argued that the IRS has exclusive jurisdiction to pursue the issue. McDougall v. Donovan, 539 F. Supp. 596 (N.D. Ill. 1982). The court found that the coordination provision of 26 U.S.C. § 4975(h) is simply an example of how Congress did not intend the Title I and Title II responsibilities to be mutually exclusive. The court commented that the Congressionally intended overlap of enforcement authority is confusing but is somewhat remedied by the Reorganization Act No. 4 of 1978.

2. Gaps and Inconsistencies in Arguments of [redacted]

We believe that the taxpayer is trying to distract the Tax Court with arguments that the statute will not support, especially in the statutory, legislative and administrative context described above. Counsel for taxpayer's own statements at the hearing are self-contradictory and exhibit a lack of understanding of the way in which ERISA was intended to be administered.

The taxpayer's counsel made frequent allegations that DOL has a superior jurisdiction over the rules of ERISA, including prohibited transactions as compared to the IRS. Counsel for petitioner stated that:

> really the primary responsibility for policing these pension plans is the Department of Labor, and the Treasury Department is more of a collection agent, and so you've got almost identical language in the Internal Revenue Code that you have in the ERISA Act, the 29 U.S. Code.

(Tr. at 11.) The statutory and administrative schemes refute that generalization. There are rules that only DOL regulates and enforces, such as those relating to breach of fiduciary duty or nontax-qualified welfare benefit plans. In turn, the IRS has the responsibility for regulating and enforcing the plan funding requirements of 26 U.S.C. § 412. Some of the tax qualification issues under 26 U.S.C. § 401(a) may be mentioned in both Title I and Title II of ERISA but regulation, as well as most enforcement, has been given to the IRS; e.g., discrimination, limits on benefits and contributions, and vesting requirements. Moreover, there are nonqualification issues over which the IRS has jurisdiction. If a plan cannot meet its 26 U.S.C. § 412 funding requirement, the plan sponsor may request from the IRS a statutory waiver of the minimum funding requirements. If that is denied or not requested, the IRS imposes a two-level excise tax on the employer under 26 U.S.C. § 4971. The 100 percent second tier tax of 26 U.S.C. § 4971(b) is designed to pressure the employer into restoring the funds to the plan, just as is the tax under 26 U.S.C. § 4975(b). Therefore, the bald statement by counsel for petitioner that the IRS is merely a collection agency for ERISA is without foundation.

For example, there is the basic perception that the IRS may not make the determination in a specific case whether or not a prohibited transaction has occurred, but must await an independent determination on that case by DOL (Tr. 7-9, 11, "12/14", 31, 32). Reorganization Act No. 4 of 1978 and the clear wording of the statute simply do not support that position. Both 29 U.S.C. § 1203(a) and 26 U.S.C. § 4975(h) state that the IRS shall "notify" DOL prior to issuing the statutory notice of deficiency and afford DOL "an opportunity" to obtain correction of the transaction or to comment on the imposition of the excise tax. In this case the Employee Plan Specialist made his determination that there was a prohibited transaction. This is evidenced by the decision that it was necessary to "notify" DOL, as well as by the description of the transaction and IRS position that was attached to the referral Form 6212-B. Once a "comment" had been received back from DOL that the IRS issuance of a statutory notice of deficiency was acceptable, then a taxpayer conference was held with [redacted]. If the IRS had not yet made a determination, as taxpayer alleged at the hearing (Tr. at 9), there would have been no need for a DOL referral. The taxpayer complained that "when somebody gets into it deep enough to determine that there may be a prohibited transaction, then there was no notice" (Tr. at 9), yet it is clear from the record and the referral that indeed the IRS had made that determination and had therefore given DOL notice. Moreover, it would have made no sense to hold a taxpayer conference until the IRS had made such a determination and had ascertained that DOL had no objections.

Contrary to [redacted]'s allegations at the hearing, there is no statutory requirement that the IRS notice of deficiency be based on a DOL investigation and determination on the specific transaction. Rather, the statute merely requires notification of DOL and opportunity for DOL to comment or act prior to the IRS issuance of a notice of deficiency based on IRS's determination. There is no requirement that DOL approve the IRS determination. The statutes do not say that the IRS notice of deficiency is to be issued pursuant to a DOL investigation and determination. The word opportunity implies time within which DOL may either comment or obtain correction. In this case the notification was sent to DOL on [redacted]. DOL responded after a month had passed. The statutory notice of deficiency was issued six months after the DOL notification. Even if DOL had not responded in [redacted], six months would surely have constituted "an opportunity" for DOL to comment or act. It is arguable that the IRS need not even receive a response from DOL as long as DOL is given the required opportunity.

This lack of understanding of ERISA is further evidenced by the comment by counsel for petitioner that the IRS was in some sense morally at fault for accelerating procedures to issue the statutory notice of deficiency before the expiration of the statute of limitations.

[redacted]

(Tr. at 12/14.) Although petitioner would not extend the statute of limitations (Tr. at 16), petitioner wanted the IRS to talk to DOL and have DOL obtain a correction rather than have the IRS issue the statutory notice.

Petitioner is glossing over a number of points. First, even if a taxpayer corrects a transaction, whether on its own or due to DOL pressure or due to IRS pressure,there can be no abatement of the first tier 5 percent tax provided under IRC § 4975(a), only abatement of the second tier 100 percent tax of IRC § 4975(b). <u>See</u> Conf. Rep. No. 93-1280 at 322, 1974-3 C.B. at 483. <u>See</u>, <u>also</u>, 29 U.S.C. § 1203(a). Correction will relieve the taxpayer of liability for the second tier tax, but only a determination that the transaction was not a prohibited transaction at all can relieve the taxpayer of a first tier tax that the IRS seeks to impose. Second, while correction may be obtained from the taxpayer through discussions with DOL, the second tier tax of 26 U.S.C. § 4975(b) is also designed as a pressure on the taxpayer to correct the transaction lest a full 100 percent tax be imposed. Conf. Rep. No. 93-1280 at 322, 1974-3 C.B. at 483. This will guarantee the protection of the innocent people in the pension plan fully as much as if DOL obtained correction. Third, in ERISA Congress changed the consequences of a prohibited transaction from plan disqualification to taxation of the "wrong-doer". In that sense, there are no adverse consequences to the innocent plan participants. In terms of protecting the innocent participants from monetary damage to their pension plan, it makes no difference to them, or under ERISA, which agency obtains correction or whether it is obtained by threat of civil liability or by the imposition of taxes on the "wrong-doers".

At the hearing [redacted] complained of surprise, that "without further ado" the notice of deficiency was issued on [redacted] (Tr. at 31), that "[redacted]" (Tr. at 32). This is inconsistent with [redacted]'s position at the [redacted] meeting. [redacted]'s representatives were told of the IRS opinion of the transaction but believed that it was not a prohibited transaction (Tr. at 8) and would not execute the extension of the statute of limitations.

In short, the petitioner wants it both ways. It will not recognize the IRS's independent authority to make a case-by-case determination of whether a taxpayer engaged in a prohibited transaction, a determination made by the IRS within the guidelines of DOL regulations, DOL opinions, and IRS regulations. Yet the taxpayer refuses to extend the statute of limitations applicable to the IRS determination. The taxpayer argues that the IRS is obliged to force DOL to start and finish a wholly separate investigation, which would result in separate and different liability, within the time remaining to the IRS. Congress did not intend such a crippling interpretation of ERISA and it is due to concerns over overlap and agency paralysis that the Reorganization Act No. 4 of 1978 was passed.

If you should have any further questions please do not hesitate to call Sarah A. Hall at FTS 566-3335.

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